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Fact Sheet for the Chairman, Subcommittee on Environment, Energy, and Natural Resources, Committee on Government Operations, House of Representatives

June 1988

LEASE-PURCHASE

Corps of Engineers Acquisition of Building in New Orleans District

136248

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

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June 7, 1988

The Honorable Mike Synar
Chairman, Subcommittee on Environment,
Energy, and Natural Resources
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

Your August 20, 1987, letter requested that we look into several aspects of the Corps of Engineers Civil Revolving Fund operated by the U.S. Army Corps of Engineers. As subsequently agreed with your office, we are providing you with data on the Corps' acquisition, through the Revolving Fund, of a district office building in New Orleans, Louisiana. On May 17, 1988, we briefed your office on the results of our audit.

Specifically, you requested information on (1) the interest rate used by the contractor in determining the lease payments, (2) the total cost to the government of the lease-purchase as compared to the outright purchase of the building, (3) the legislative background pertaining to expenditure controls in purchasing capital items through the Revolving Fund, and (4) the year in which the Corps will report the principal portion of the lease payments to the Congress as a capital expenditure. This information is in appendix I.

In order to obtain the information, we interviewed Corps officials at the Washington, D.C., headquarters and the New Orleans district offices. We also interviewed Army Audit Agency (AAA) auditors and reviewed the working papers from an earlier audit they performed pertaining to the acquisition of the New Orleans district building. In addition, we reviewed contractual agreements, accounting records, legislative documents, Corps regulations, and two AAA reports. The two reports were (1) U.S. Army Corps of Engineers, New Orleans District, New Orleans, Louisiana, dated June 4, 1986, and (2) Revolving Fund Accounting, New Orleans Engineer District, New Orleans, Louisiana, dated June 24, 1987.

The Corps entered into a lease-purchase agreement for an office building in New Orleans on September 1, 1985. We estimate that using the lease-purchase option instead of purchasing the building directly will result in a loss to the federal government of about $23.5 million over the 25-year lease term. If payments for taxes and insurance are considered, the cost difference would be about $31.3 million.

As agreed with your office, we did not obtain official agency comments on a draft of this report. The views of responsible agency officials were sought during the course of our work and are incorporated where appropriate. Unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from its date. At that time we will send copies to the Corps of Engineers and other interested parties. We will also make copies available to others on request. If you have any questions regarding this report, please call me at (202) 275-9454.

Sincerely yours,

John F. Simonette

John F. Simonette
Associate Director

FACTS CONCERNING THE ACQUISITION OF THE NEW ORLEANS DISTRICT OFFICE BUILDING

BACKGROUND

In 1983, section 103 of Public Law 98-50 authorized the Secretary of the Army to enter into a purchase contract for the acquisition of new buildings for the Corps district located in New Orleans. The contract was to provide for payment of the purchase price, not to exceed $38 million and reasonable interest, by lease or installment payments over a period not to exceed 25 years. Subsequently, the Corps awarded a contract to construct an office building with the intention of entering into a lease-purchase agreement. On September 1, 1985, the Corps entered into a lease-purchase agreement requiring the government to make monthly lease-payments of $332,500 (including $26,000 for taxes and insurance, payable by the contractor) or about $4 million per year for a period not to exceed 25 years. At the end of the 25-year lease period, ownership of the building passes to the government at no additional cost.

The lease-purchase is being financed through the Revolving Fund. The Revolving Fund provides for the acquisition, operation, and maintenance of plants and equipment used in civil works functions. The Revolving Fund owns all the land, structures, dredges, and other plants and equipment that serve two or more civil works projects. Projects and appropriations benefitting from the use of the assets reimburse the Revolving Fund. The concept of the Revolving Fund is that it should operate within its own resources, rather than from annual appropriations.

EFFECTIVE INTEREST RATE

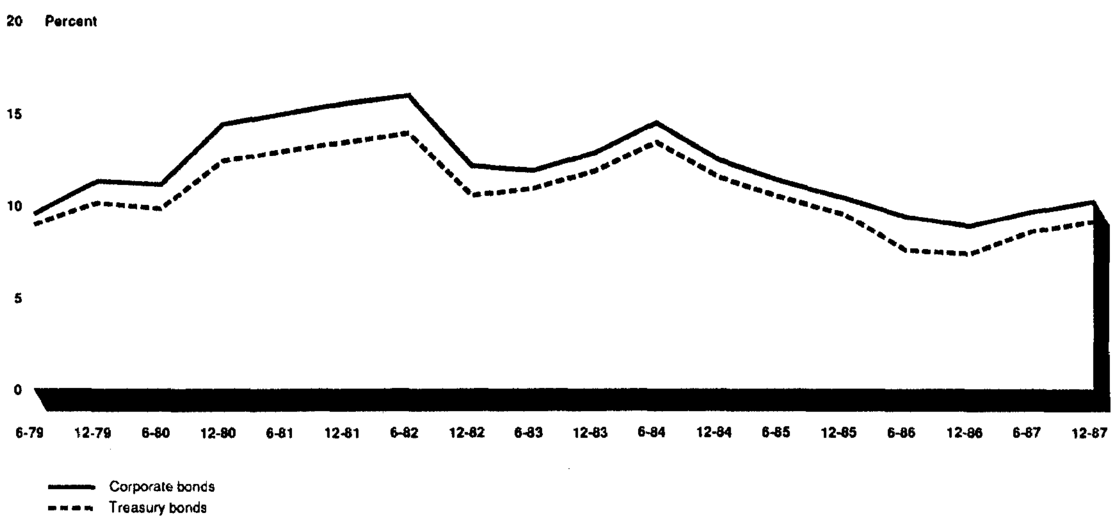
The contract documents contain no record of the interest rate used by the contractor in determining monthly lease payments. The Corps' request for proposal did not specifically require the contractor to state an interest rate, and the proposal submitted by the contractor did not contain one. In a June 1986 report, the Army Audit Agency (AAA) reviewed the building acquisition and could not identify a stated interest rate. The contractor proposal indicated the total cost of the building as $21,890,000 and, using this amount, AAA imputed an effective interest rate of approximately 16.5 percent. According to Corps' records, the contractor informed the Corps that the proposal did not include profit and that, with profit added, the cost of the building would be $24,000,000. Based on this amount, the effective interest rate is approximately 15 percent. The Corps also used this $24,000,000 figure as the basis for recording the building in its accounting records.

Our analysis of the signed lease-purchase agreement, which lists the amount to be paid by the government each year in the event the Corps defaults, appears to confirm that the value of the building that the Corps used was accurate. At the end of the first year, the payout amount was $24,740,000. Corps officials told us that the payout amount was more than the original building value because of prepayment penalties that would be incurred on the loan taken out by the contractor.

COST COMPARISON

Over the 25-year term of the lease, the interest cost associated with financing the building through the lease-purchase agreement exceeds the government's financing cost by about $23.5 million. This difference can be attributed to the lower cost of the federal government providing its own financing. As shown in figure I.1, Treasury's historical cost of borrowing funds is less than that of the corporate sector. For example, in December 1987, the average yield for 30-year Treasury bonds was 9.12 percent, while the yield for new corporate Aa[1] bonds was 10.22 percent.

Figure I.1: Average Yields of 30-Year Treasury and Corporate Bonds



Corporate bonds rates are for securities rated Aa.

Source: Treasury Bulletin, Winter Issue, March 1988.

[1]According to Moody's Investors Service, bonds which are rated Aa are judged to be of high quality by all standards. Although Aaa bonds are rated higher, the Treasury Bulletin does not provide the necessary information to make a comparison between Treasury securities and Aaa bonds.

The cost of purchasing the building through lease-purchase over a 25-year period and the government's cost of acquiring the building outright at the time it is completed can be compared by considering the time value of money. In order to make this comparison, we determined the total cost of the lease payments over the 25-year term of the lease and estimated the total cost to the government had it financed the purchase of the building over the same 25-year period. Our calculations are explained below.

Total lease payments for principal and interest over the 300-month term of the lease will be about $92 million. The $92 million is calculated by multiplying the net monthly lease payments of $306,500 by the 300 months which constitute the lease term. The estimated principal and interest costs to the government, had it financed the purchase over the 25 years, would be about $68.5 million. This amount consists of the cost of the building, $24 million, and related interest costs of $44.5 million. The interest rate used in making this computation was 10.61 percent, which was the average yield on Treasury 30-year bonds[2] at the time the lease-purchase was signed.

According to the Corps, it is also paying the contractor about $26,000 monthly for taxes and insurance. Since these costs are not normally paid for buildings owned by the federal government, the Corps is incurring about $7.8 million in additional costs over the life of the agreement because the lease-purchase option was used. If this amount is added to the interest cost difference, the total additional cost over the 25-year lease term would be about $31.3 million. The present value of the $31.3 million difference is about $10.9 million, using the Treasury rate.

Based on provisions in the lease-purchase agreement, the government has the option to purchase the office building prior to the end of the lease term. Such buy-out options are available to the Corps at the end of the 10th, 15th, and 20th years. Specific purchase option prices are identified in the lease-purchase agreement. The AAA reported in June 1986 that purchasing the building at the end of the 10th year would avoid $34.7 million of contract-related costs. The AAA calculated the potential cost avoidance by subtracting the purchase option price ($20.5 million) and total prior payments ($36.8 million) from the total payments ($92 million) due over the 25-year lease term.

Again, taking into account the time value of money, we calculated that the federal government would avoid costs of about

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[2]The Treasury 30-year bond rate was selected since Treasury does not routinely publish rates for 25-year bonds in its Treasury Bulletin.

$15.5 million if the Corps were to purchase the building at the end of the 10th year (September 1, 1995). Our calculation differs from that of AAA's in one respect. We estimated the total cost to the government, had it financed the $20.5 million purchase option price, at about $39.7 million at the end of year 10. We then subtracted this amount and the total prior payments from the total payments due over the lease term to arrive at our estimated cost avoidance. Since Treasury's cost of funds cannot be known as of the purchase option date, we assumed a Treasury borrowing rate of 10 percent.

LEGISLATIVE BACKGROUND

When the Revolving Fund was established in 1953 under Public Law 83-153, the Congress provided that the capital of the Revolving Fund shall not exceed $140 million. The Corps defined the capital or corpus of the Revolving Fund as total assets less liabilities and reserves. According to the Corps, this ceiling was adequate until 1965, when an increased workload and inflation required that the Corps request annual increases in the corpus ceiling. The Corps believed the restrictions on the corpus ceiling limited the income that could be generated from plant rentals, which in turn adversely affected the management of the Revolving Fund.

Thus, the Corps sought to have an annual capital expenditure ceiling substituted for the corpus ceiling. The Congress responded in 1978 by passing Public Law 95-482, the continuing appropriations for fiscal year 1979 (continuing resolution). The continuing resolution provided for

> ". . . such amounts as may be necessary, notwithstanding any other provision of this joint resolution, for the fiscal year ending September 30, 1979, for programs, projects, and activities to the extent and in the manner provided for in the Energy and Water Development Appropriation Act, 1979 (H.R. 12928)."

House bill 12928 had been passed by the Congress but vetoed by President Carter on October 5, 1978, for reasons unrelated to the corpus ceiling.

Because the continuing resolution incorporated H.R. 12928, the following provision of the House bill became effective:

> "The total accrued expenditures of the capital investment program of the revolving fund shall not exceed $102,500,000 in fiscal year 1979 and the total capital of the revolving fund shall hereinafter not be limited."

Now, according to a Corps official, the Corps has an informal agreement with the House and Senate Appropriations Committees to identify capital items valued at $700,000 or more in its yearly budget submissions.

WHEN WILL YEARLY PRINCIPAL EXCEED $700,000?

If the Corps continues the current practice of reporting to the Congress all planned capital expenditures over $700,000 from the Revolving Fund, the principal portion of the lease payments should be identified in budget submissions in fiscal year 2000, as shown in figure I.2.

Figure I.2: Principal Payments by Fiscal Year

Fiscal year	Principal payments (thousands)	Fiscal year	Principal payments (thousands)
1985	$ 7.5[a]	1998	$ 578.1
1986	97.2	1999	670.8
1987	112.8	2000	778.2
1988	130.8	2001	902.9
1989	151.8	2002	1,047.5
1990	176.1	2003	1,215.3
1991	204.3	2004	1,410.0
1992	237.0	2005	1,635.9
1993	275.0	2006	1,898.0
1994	319.1	2007	2,202.1
1995	370.2	2008	2,554.8
1996	429.5	2009	2,964.1
1997	498.3	2010	3,132.5[b]

[a]One principal payment was made during this year.

[b]Eleven principal payments will be made during this year.

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